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EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

REPORTING FINANCIAL HIGHLIGHTS AND SCHEDULE OF INVESTMENTS BY NONREGISTERED INVESTMENT PARTNERSHIPS: AN AMENDMENT TO THE AUDIT AND ACCOUNTING GUIDE *AUDITS OF INVESTMENT COMPANIES* AND AICPA STATEMENT OF POSITION 95-2, *FINANCIAL REPORTING BY NONPUBLIC INVESTMENT PARTNERSHIPS*

JULY 15, 2003

**Issued by the Accounting Standards Executive Committee
American Institute of Certified Public Accountants**

**Comments should be received by September 15, 2003, and sent by electronic mail to
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AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775**

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July 15, 2003

Accompanying this letter is an exposure draft of a proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships*. A summary of the significant provisions of the proposed SOP follows this letter.

The purpose of the exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties. The Accounting Standards Executive Committee (AcSEC) invites comments on all matters in the proposed SOP and particularly on the following issues. Respondents should refer to specific paragraph numbers and include reasons for any suggestions or comments.

Clarification of Certain Terms

Issue 1: The proposed SOP carries forward and elevates in authority guidance in Technical Practice Aid (TPA) 6910.04 that clarified how the terms *classes*, *units*, and *theoretical investment* should be interpreted when reporting financial highlights by nonregistered investment partnerships. Are the proposed clarifications to those terms appropriate and operational in amended paragraph 7.65 of the AICPA Audit and Accounting Guide *Audits of Investment Companies* (Guide)? Is the guidance sufficient to provide for consistent application by nonregistered investment partnerships? If not, how should the terms be clarified?

Refer to paragraph 11 and paragraph A-10 in the “Basis for Conclusions.”

Disclosure of Per Share or Per Unit Data

Issue 2: The proposed SOP carries forward and elevates in authority guidance in TPA 6910.05 that clarified that nonregistered investment partnerships should disclose per share or per unit data for each reporting share class related to nonmanaging investors in accordance with the Guide’s requirement. Is the proposed guidance appropriate and operational in amended paragraph 7.66 of the Guide? Is the guidance sufficient to provide for consistent application by nonregistered investment partnerships? If not, what information should be disclosed in the per share data for nonregistered investment partnerships?

Refer to paragraph 12 and paragraph A-11 in the “Basis for Conclusions.”

Reporting of Classes of Shares

Issue 3: The proposed SOP carries forward and elevates in authority guidance in TPA 6910.06 that clarified that paragraph 7.65 of the Guide requires nonregistered investment partnerships to disclose financial highlights for each class of common share of nonmanaging investors in their general-purpose financial statements. Is the proposed guidance appropriate and operational in amended paragraph 7.65 of the Guide? Is the guidance sufficient to provide for consistent application by nonregistered investment partnerships?

Refer to paragraph 11.

Determining Average Net Assets When Computing Financial Ratios

Issue 4: The proposed SOP carries forward and elevates in authority the guidance in TPA 6910.07 that clarified that, when computing the net investment income and expense ratios in accordance with paragraph 7.67 of the Guide, nonregistered investment partnerships should calculate average net assets (ANA) based on the partnership's net assets measured at each accounting period. Is the proposed guidance appropriate and operational in amended paragraph 7.67(a) of the Guide? Is the guidance sufficient to provide for consistent application by nonregistered investment partnerships?

Refer to paragraph 13 and paragraphs A-12 to A-14 in the "Basis for Conclusions."

Computation of the Expense and Net Investment Income Ratios and Additional Financial Highlights Disclosures for Certain Limited-Life Investment Partnerships

Issue 5: The proposed SOP carries forward and elevates in authority the guidance in TPA 6910.08 that clarified that all nonregistered investment partnerships should calculate the expense ratio based on average net assets. Additionally, for certain investment partnerships that obtain capital commitments from investors and periodically call capital under those commitments to make investments (principally limited-life venture capital investment partnerships), the proposed SOP would supplement the Guide by requiring disclosure of the total committed capital of the partnership, the year of formation of the partnership and the year the partnership made its first investment, and the ratio of the total contributed capital to committed capital. It is believed that these disclosures will provide meaningful information to financial statement users. Is the proposed guidance appropriate and operational in amended paragraph 7.67 of the Guide? Is the guidance sufficient to provide for consistent application by nonregistered investment partnerships?

Refer to paragraph 13 and paragraph A-15 to A-18 in the "Basis for Conclusions."

Computation of Financial Ratios by Funds-of-Funds and Master-Feeder Funds

Issue 6: The proposed SOP carries forward and elevates in authority the guidance in TPA 6910.09 that clarified that nonregistered funds-of-funds should compute net investment income and expense ratios based on the net investment income and expenses presented in the funds-of-funds' statements of operations only. However, in computing those ratios at the master-feeder level, the feeder should include its proportionate share of income and expenses of the master, as included in the feeder's statement of operations. Is the proposed guidance appropriate and operational in amended paragraph 7.67(c) of the Guide? Is the guidance sufficient to provide for consistent application by nonregistered investment partnerships?

Refer to paragraph 13 and paragraph A-19 in the "Basis for Conclusions."

Computation of the Total Rate of Return

Issue 7: The proposed SOP carries forward, in part, and elevates in authority the guidance in TPA 6910.10 that clarified the application of paragraph 7.68(c) of the Guide to indicate that when calculating the total return ratio nonregistered investment partnerships (except as indicated in Issue 8 for nonregistered investment partnerships that meet certain criteria) should calculate the change in value of a theoretical investment by comparing the aggregate ending value of each class of investor with the aggregate beginning value of each such class, adjusted for cash flows related to capital contributions or withdrawals during the period. Furthermore, the guidance indicates that when capital cash flows occur during the reporting period, returns are geometrically linked based on capital cash flow dates. Lastly, the guidance indicates that total return should be reported both before and after any incentive allocation or fee, with the effect of such allocations computed on a weighted

average aggregate basis. Is the proposed guidance appropriate and operational in amended paragraph 7.68(c) of the Guide? Is the guidance sufficient to provide for consistent application by nonregistered investment partnerships?

Refer to paragraph 14 and paragraphs A-20 and A-21 in the “Basis for Conclusions.”

Reporting Total Return for Certain Limited-Life Nonregistered Investment Partnerships

Issue 8: The proposed SOP amends paragraph 7.68(c) of the Guide to indicate that nonregistered investment partnerships that by the terms of their offering documents (1) have limited lives, (2) do not continuously raise capital and are not required to redeem their interests upon investor request, (3) have as a predominant operating strategy the return of the proceeds from disposition of investments to investors, (4) have limited opportunities, if any, for investors to withdraw prior to termination of partnership, and (5) do not invest significantly in market-traded securities, should compute and disclose an Internal Rate of Return since inception (IRR) as of the beginning and end of the period as a performance measure of their rate of return. The proposed guidance also concludes that, for these funds, the effect of incentive allocations or fees would not be separately reported, as in many cases incentives are based on cumulative returns, creating severe practical difficulties in computing the IRR inclusive and exclusive of incentives. It is expected that this guidance will apply to venture capital investment partnerships and similar private equity funds.

Is the proposed performance measurement calculation in amended paragraph 7.68(d) of the Guide appropriate? Does it provide meaningful and useful information for users of nonregistered investment partnership financial statements? Does the term “Internal Rate of Return” require further definition? Is the proposed IRR to be used by certain nonregistered investment partnerships as a performance measure as appropriate as the *total rate of return* used by other types of investment partnerships? Has the limitation on usage of an IRR as a performance measure been structured appropriately, or is it too broad or too narrow? If too narrow, to which other types of partnerships should this guidance apply?

Refer to paragraph 14 and paragraphs A-22 to A-28 in the “Basis for Conclusions.”

Presentation of Derivatives in the Condensed Schedule of Investments

Issue 9: The proposed SOP amends paragraph 7.12 of the Guide to require that the number of contracts and range of expiration or maturity dates should be presented in the condensed schedule of investments if the fair value (or, for open futures contracts, cumulative appreciation (depreciation)) of a specific type of derivative and underlying (for example, equity index of a particular stock exchange, U.S. Treasury Bond, or natural gas) exceeds 5 percent of net assets, regardless of counterparty. Is the proposed basis appropriate and operational? Does the proposed guidance provide for more consistent presentation of similar contracts? If not, what other basis (for example, notional value) would be appropriate to measure derivatives for presentation in the condensed schedule of investments in a manner that would provide consistent presentation of similar contracts?

Refer to paragraph 10 and paragraphs A-4 to A-7 in the “Basis for Conclusions.”

Additional Disclosures in the Condensed Schedule of Investments for Investments in Nonregistered Investment Partnerships

Issue 10: The proposed SOP amends paragraph 7.12 of the Guide to require additional qualitative disclosures for investments by investment partnerships in other nonregistered investment partnerships. Are those disclosures appropriate? Is the information available?

Refer to paragraph 10 and paragraphs A-1 to A-3 in the “Basis for Conclusions.”

Effective Date

Issue 11: The SOP would be effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Assuming the issuance of a final SOP during the fourth quarter of 2003, is the effective date appropriate? Why or why not? Are there data availability or other limitations that, in particular, may make it impractical to substitute an annualized Internal Rate of Return since inception calculation for total return for qualifying entities?

Refer to paragraph 17.

Transition

Issue 12: The proposed SOP would be required to be applied prospectively from the beginning of the year of adoption. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. Do you agree with this transition? Why or why not?

Refer to paragraph 17.

Comments on the exposure draft should be sent by electronic mail to Fferrer@aicpa.org or addressed to Fabiola Ferrer, Technical Manager, Accounting Standards, File 3170.NIP, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by September 15, 2003.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA for one year after September 15, 2003.

Sincerely,

Mark V. Sever, CPA
Chair
Accounting Standards
Executive Committee

Richard H. Grueter, CPA
Chair
Reporting Financial Highlights
and Schedule of Investments
By Nonregistered Investment
Partnerships Task Force

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SUMMARY

This Statement of Position (SOP) provides guidance on the application of certain provisions of the AICPA Audit and Accounting Guide *Audits of Investment Companies* (the Guide) and AICPA SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, that are directed to the reporting by investment partnerships of financial highlights and the schedule of investments. It amends certain provisions of the Guide and of SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment companies. Additionally the SOP incorporates and elevates in authority the guidance provided in previously issued Technical Practice Aids (TPAs) 6910.04 through 6910.10. The guidance in certain TPAs was revised as a result of further deliberations on the above items. Thus the guidance provided by those TPAs is now included in the issues indicated below. The guidance in other TPAs, however, has been carried forward without change.

This SOP provides that:

- Nonregistered investment partnerships, other than those that meet certain criteria as indicated in the next bullet, should calculate and disclose as a financial highlight an annual total rate of return based on a “geometric linking” of performance for each discrete period within a year for which invested capital is constant.
- Nonregistered investment partnerships that meet the criteria by the terms of their offering document as indicated in the next sentence should calculate and disclose as a financial highlight an internal rate of return since inception for the current and prior accounting period. The partnership criteria are: (1) have limited lives, (2) do not continuously raise capital and are not required to redeem their interests upon investor request, (3) have as a predominant operating strategy the return of the proceeds from disposition of investments to investors, (4) have limited opportunities, if any, for investors to withdraw prior to termination of partnership, and (5) do not invest significantly in market-traded securities.
- Nonregistered investment partnerships should calculate the denominator of their expense and net investment income ratios based on average net assets (ANA).
- Nonregistered investment partnerships whose expenses are based on committed capital should provide additional disclosures of the total committed capital of the partnership, the year of formation of the partnership and the year the partnership made its first investment, and the ratio of the total contributed capital to committed capital.
- Nonregistered investment partnerships should disclose the number of contracts and range of expiration or maturity dates of derivative instruments in the condensed schedule of investments based on whether the fair value (or, for open futures contracts, cumulative appreciation (depreciation)) of a specific type of derivative and underlying (for example, equity index of a particular stock exchange, U.S. Treasury Bond, or natural gas) exceeds 5 percent of net assets, regardless of counterparty.
- “Funds-of-funds” partnerships should provide certain qualitative disclosures in addition to the name of the investment for investments in nonregistered investment partnerships that exceed 5 percent of net assets.
- Nonregistered investment partnerships should calculate ANA by using the fund’s weighted ANA (as measured at each accounting period) and any other period when capital is contributed or withdrawn.

- Funds-of-funds and master-feeder funds should calculate net investment income and expense ratios based on the net investment income and expenses reported in the statement of operations.

This SOP is effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of the SOP should be applied prospectively from the beginning of the year of adoption.

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FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a proposed final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Proposed Statement of Position

Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide *Audits of Investment Companies* and AICPA Statement of Position 95-2, *Financial Reporting by Nonpublic Investment Partnerships*

INTRODUCTION AND BACKGROUND

1. Historically, the guidance in the AICPA Audit and Accounting Guide *Audits of Investment Companies* (Guide) has been related principally to investment companies registered under the Investment Company Act of 1940 and similar entities. The most recent comprehensive review and revision of the Guide, completed in November 2000, made substantial changes to clarify the differences in accounting and reporting by registered investment companies and nonregistered investment partnerships (for example, explicitly distinguishing the extent of financial statement disclosures required under generally accepted accounting principles (GAAP) and Securities and Exchange Commission (SEC) requirements).

2. Nonregistered investment partnerships, nonetheless, continue to raise questions as to the application of certain provisions of the Guide, principally because of the differences between the operating structures of nonregistered investment partnerships and registered investment companies.

3. In particular, those questions relate to paragraphs 7.65 and 7.68 of the Guide, which address the presentation of financial highlights.

4. AICPA Accounting Standards Executive Committee's (AcSEC's) Planning Subcommittee (PSC) formed a task force in January 2002 to prepare guidance in the form of Technical Practice Aids (TPAs) to assist practitioners on timely basis in computing and presenting financial highlights in accordance with the Guide's requirements. That task force's charge was limited to clarifying the application of the provisions of the Guide to nonregistered investment partnerships rather than modifying the requirements of the Guide.

5. However, implementation of the TPAs revealed issues, particularly for venture capital partnerships, regarding the relevance of the expense and total return ratios. The industry asserts that the methods required to calculate certain financial highlights are not well suited for these partnerships due to their operational structure, and that the implementation of the provisions of the Guide may result in disclosing information that is either irrelevant or in a format that investors cannot easily understand. In particular, some have asserted that the *geometric linking* method of computing total return (as required by paragraph 7.68(c) of the Guide and discussed in TPA 6910.10) at times can produce what are viewed as misleading results for those funds.

6. Paragraph 7.12 of the Guide requires disclosure of derivative positions exceeding 5 percent of net assets based on their fair value. Questions have been raised as to whether the fair value of a derivative position is always the best determinant of whether information about that position should be presented in the schedule of investments, or whether other determinants, such as notional amounts, for certain kinds of derivative positions would result in more useful reported information. Questions also have been raised as to whether derivatives with the same underlying but different counterparties or expiration or delivery dates should be aggregated.

7. Furthermore, AcSEC believes that disclosing only the names of other nonregistered investment partnerships in which the reporting partnership has invested provides little, if any,

meaningful information to the financial statement user and thus believes that a qualitative description of the investee's principal investment strategies (including any particular specialization) should provide information that would allow for a better understanding of the nature of the investment.

8. The purpose of this Statement of Position (SOP) is to provide disclosure guidance to clarify the application of certain provisions of the Guide to nonregistered investment partnerships.

APPLICABILITY AND SCOPE

9. This SOP applies only to nonregistered investment partnerships that are within the scope of the Guide. Footnote 13 to paragraph 7.12 of the Guide is amended as follows to clarify that only certain brokers and dealers in securities under the Securities Exchange Act of 1934 are excluded from the requirement of paragraph 7.12. Inserts are shown in italics and underlined; deletions are shown with strikethrough.

Included are **hedge funds**, limited liability companies, limited liability partnerships, limited duration companies, and offshore investment companies with similar characteristics, and commodity pools subject to regulation under the Commodity Exchange Act of 1974. Excluded are investment partnerships ~~that are~~ regulated as brokers and dealers in securities ~~subject to regulation~~ under the Securities Exchange Act of 1934 (registered broker-dealers) ~~and~~ that manage funds only for those who are officers, directors, or employees of the general partner.

CONCLUSIONS

10. Paragraph 7.12 of the Guide and paragraph 11 of SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships* (as amended by SOP 01-1, *Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools*), (refer to Appendix B for the changes to SOP 95-2), which provide guidance relative to the condensed schedule of investments, are amended by adding the guidance shown in italics and underlined:

Schedule of Investments

7.12 Investment partnerships¹³ that are exempt from SEC registration under the Investment Company Act of 1940 (the 1940 Act) should—

- a. Categorize investments by the following:
 1. Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)
 2. Country or geographic region
 3. Industry

Report the percent of net assets that each such category represents and the total value and cost for each category in (a)(1) and (a)(2). Derivatives for which the underlying is not a security should be categorized by broad category of underlying (for example, grains and feeds, fibers and textiles, foreign currency, or equity indices) in place of categories (a)(2) and (a)(3).

b. Disclose the name, shares or principal amount, value, and type of the following:

1. Each investment (including short sales), constituting more than 5 percent of net assets except for derivative instruments as discussed in (d) and (e) below.
2. All investments in any one issuer aggregating more than 5 percent of net assets except for derivative instruments as discussed in (d) and (e) below.

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

c. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments and categorize them as required by (a) above.

d. Disclose the number of contracts, range of expiration dates, and cumulative appreciation (depreciation) for open futures contracts of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets.

e. Disclose the range of expiration dates and fair value for all other derivatives (such as forwards, swaps [such as interest rate and currency swaps], and options) of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds) regardless of counterparty, exchange, or delivery date, where fair value exceeds 5 percent of net assets.

f. Provide the following additional qualitative description for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets:

- the investment objective
- restrictions on redemption (that is, liquidity provisions)
- either the total amount of management fees and incentive allocations or fees borne indirectly during the period, or the management fee and incentive allocation/fee rates applicable to the investment.

¹³ Included are hedge funds, limited liability companies, limited liability partnerships, limited duration companies, and offshore investment companies with similar characteristics, and commodity pools subject to regulation under the Commodity Exchange Act of 1974. Excluded are investment partnerships that are regulated as brokers and dealers in securities ~~subject to regulation~~ under the Securities Exchange Act of 1934 (registered broker-dealers) and that manage funds only for those who are officers, directors, or employees of the general partner.

11. Paragraph 7.65 of the Guide, which requires disclosure of financial highlights, is amended by adding the guidance shown in italics and underlined to clarify how nonregistered investment partnerships should interpret the terms *classes*, *units*, and *theoretical investment* when reporting financial highlights. Additionally, the paragraph is amended to indicate that nonregistered investment partnerships should disclose financial highlights of each class of common shares of nonmanaging investors in the general-purpose financial statements.

Financial Highlights

7.65 Financial highlights (see paragraph 7.01) should be presented either as a separate schedule or within the notes to the financial statements for each class of common shares outstanding. Per share amounts presented are based on a share outstanding throughout each period presented. Investment companies with multiple classes of shares may present financial highlights only for those classes of shares that are included in reports to such shareholders. In such cases, the investment company should include appropriate disclosures related to all classes so as to ensure that the financial statements are complete (for example, detail of capital share activity in the statement of changes in net assets or notes to financial statements). Nonregistered investment partnerships should disclose per share data for all common classes in general-purpose financial statements. However, it is permissible for financial highlights to be presented only for those classes of shares that are included in reports to those classes.

Nonregistered investment partnerships, when disclosing financial highlights, should interpret the terms classes, units, and theoretical investments as follows:

a. Classes. Only the classes related to the nonmanaging investors (that is, classes of investors that do not consist exclusively of managing investor interests) are considered to be the common interests requiring financial highlight disclosure. Nonregistered investment funds typically have two classes of ownership interest, with one class being the management interest in the fund and the other being the investment interest. For unitized funds (that is, funds with units specifically called for in the governing underlying legal or offering documents), the management interest usually is a voting class and the investment interest is a nonvoting class. Temporary series of shares (that is, shares that are intended at the time of issuance to be consolidated at a later date with another specified series of shares that remains outstanding indefinitely) are not considered separate classes. For nonunitized funds, the management interest usually is the general partner class and the investment interest usually is the limited partner class. Generally, a "class" has certain rights as governed by underlying legal documents or offering documents, and local law. Rights to certain investments that do not otherwise affect the rights available under the underlying legal documents and local law do not ordinarily represent a separate share class. For example, rights to income and gains from a specific investment attributed solely to investors at the date the investment is made ("side-pocket" investments) are not considered to give rise to a share class. Similarly, a temporary series of shares is not considered a share class.

b. Units. Only funds with units specifically called for in the governing underlying legal or offering documents should be considered unitized. Some funds may employ units for convenience in making allocations to investors for internal accounting or bookkeeping purposes, but the units are not required or specified by legal or offering documents, and for all other purposes operate like non-unitized investment partnerships. For per share operating performance, those funds are not considered unitized. If a fund is not unitized, only investment returns (either total return or internal rate of return) and net investment income and expense ratios are required to be disclosed as indicated in paragraphs 7.67 and 7.68.

c. Theoretical investment. The term "theoretical investment" in paragraph 7.68(c) should be considered as the actual aggregate amount of capital invested by each reporting class of investor as of the beginning of the fiscal reporting period, adjusted for cash flows related to capital contributions or withdrawals during the period.

12. Paragraph 7.66 of the Guide, which requires per share information to be disclosed as financial highlights, is amended by adding the wording in italics and underlined below.¹

7.66 The following per share information should be presented for registered investment companies and for investment companies that compute unitized net asset value (a more detailed discussion of calculation methods for registered investment companies may be found in the instructions for preparation of registration statements on Forms N-1A and N-2). *Nonregistered investment partnerships that compute unitized net asset value should disclose information for each reporting share class related to nonmanaging investors. The information should be disclosed for each major category affecting net asset value per share (as shown in the statement of operations and statement of changes in net assets of the fund). The caption descriptions in the per share data should be the same captions used in the statement of operations and statement of changes in net assets to allow the reader to determine which components of operations are included in or excluded from various per share data.*

- a. Net asset value at the beginning of the period
- b. Per share net investment income or loss, which, for registered investment companies, is calculated in accordance with the requirements of Form N-1A or N-2. Other methods, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, are acceptable. If used by a registered investment company, the method employed must be disclosed in a note to the table in conformity with SEC requirements.
- c. Realized and unrealized gains and losses per share, which are balancing amounts necessary to reconcile the change in net asset value per share with the other per share information presented. The amount shown in this caption might not agree with the change in aggregate gains and losses for the period. If such is the case, the reasons should be disclosed.
- d. Total from investment operations, which represents the sum of net investment income or loss and realized and unrealized gain or loss.
- e. Distributions to shareholders should be disclosed as a single line item except that tax return of capital distributions should be disclosed separately. Details of distributions should conform to those shown in the statement of changes in net assets.
- f. Purchase premiums, redemption fees, or other capital items
- g. Payments by affiliates (paragraphs 7.49 through 7.51)
- h. Net asset value at the end of the period

¹The proposed Statement of Position *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies will also amend paragraph 7.66 of the Guide.

- i. Market value at the end of the period (Form N-2 registrants only).

13. Paragraph 7.67 of the Guide, which provides guidance as to the disclosure of the expense and net investment income ratios, is amended by adding the wording in italics and underlined:

7.67 Ratios of expenses and net investment income to average net assets are generally annualized for periods less than a year. The ratio of expenses to average net assets should be increased by brokerage service and expense offset arrangements (see paragraphs 7.40 and 7.41).

- a. When determining net investment income and expense ratios nonregistered investment partnerships should calculate average net assets (ANA) by using the fund's (or class') weighted average net assets as measured at each accounting period (for example, daily, weekly, monthly, quarterly) and any other period when capital is contributed or withdrawn from the fund.

The expense and net investment income ratios should be calculated by nonregistered investment partnerships based on the expenses allocated to each common or investor class (for example, the limited partner class) prior to the effects of any incentive allocation. Adequate disclosure should be made to indicate that the net investment income ratio does not reflect the effects of any incentive allocation.

Generally, the determination of expenses for computing these ratios should follow the presentation of expenses in the fund's statement of operations. Accordingly, if the manager's or general partner's incentive is structured as a fee rather than an allocation of profits, the incentive fee would be factored into the computation of an expense ratio. Because an incentive allocation of profits is not presented as an expense, it should not be considered part of the expense ratio. However, to avoid potentially significant inconsistencies in ratio presentations based solely on the structuring of incentives as fees or allocations, all incentives should be reflected in the disclosure of financial highlights. See paragraph 7.87 for an example of that disclosure.

Additionally, for the expense ratio, disclosure should be made of the effect of any agreement to waive or reimburse fees and expenses to each reporting class as a whole, as described in paragraph 7.38, and of expense offsets, as described in paragraphs 7.40 and 7.41. Agreements to waive a portion or all of certain fees to a specific investor, which do not relate to the share class as a whole, do not require disclosure in the financial highlights. However, as ratios are calculated for each common class taken as a whole, the financial statements should disclose that an individual investor's ratio may vary from those ratios.

- b. Investment companies that obtain capital commitments from investors and periodically call capital under those commitments to make investments (principally limited-life venture capital and private equity investment partnerships) should disclose in the financial highlights the following items: total committed capital of the partnership (including general partner), the year of formation of the entity, the year that the entity made its first investment, and the ratio of total contributed capital to total committed capital.

- c. Funds-of-funds should compute the expense and net investment income ratios using the expenses presented in the fund's statement of operations. Therefore, funds-of-funds typically should compute these ratios based on the net investment income and expense items at the fund-of-funds level only. Adequate disclosure should be made so that it is clear to users that the ratios do not reflect the funds-of-funds' proportionate share of income and expenses of the underlying investee funds. In a master-feeder structure, the feeder should include its proportionate share of the income and expenses of the master when computing the ratios at the feeder level.

14. Paragraph 7.68 of the Guide, which provides guidance relative to total return disclosure in the financial highlights, is amended by adding the wording in italics and underlined:

7.68 Total return is required to be presented for all investment companies (for interim periods, the disclosure should include whether or not total return is annualized), and should be computed as follows:

- a. For nonregistered investment companies organized in a manner utilizing unitized net asset value and for N-1A registrants, based on the change in the net asset value per share during the period, and assuming that all dividends are reinvested.
- b. For Form N-2 registrants, based on change in market value of the fund's shares taking into account dividends reinvested in accordance with the terms of the dividend reinvestment plan or, lacking such a plan, at the lesser of net asset value or market price on the dividend distribution date (Total investment return computed based on net asset value per share may also be presented if the difference in results between the two calculations is explained.)
- c. For investment companies not utilizing unitized net asset value, including investment partnerships, based on the change in value during the period of a theoretical investment made at the beginning of the period. The change in value of a theoretical investment is measured by comparing the aggregate ending value of each class of investor with the aggregate beginning value of each such class, adjusted for cash flows related to capital contributions or withdrawals during the period.

If capital cash flows occur during the reporting period, returns are geometrically linked based on capital cash flow dates. In general, "geometrically linking" requires the computation of performance for each discrete period within a year in which invested capital is constant (that is, for each period between investor cash flow dates), then multiplying those performance computations together to obtain the total return for a constant investment outstanding for the entire year.

Because incentive allocations or fees may vary among investors within a class, total return for reporting classes subject to an incentive allocation or fee should report total return before and after the incentive allocation or fee for each reporting class taken as a whole. The effect of incentive allocations on total return is computed on a weighted average aggregate basis. That results in an incentive

computation less than the maximum if, for example, certain partners had loss carryovers at the beginning of the period.

- d. Investment companies, as defined in paragraphs 1.03 through 1.06, that by the terms of their offering documents (1) have limited lives, (2) do not continuously raise capital and are not required to redeem their interests upon investor request (obtaining initial capital commitments from investors at time of organization and subsequently drawing on those commitments to make investments is not considered "continuous" for this purpose), (3) have as a predominant operating strategy the return of the proceeds from disposition of investments to investors, (4) have limited opportunities, if any, for investors to withdraw prior to termination of partnership, and (5) do not invest significantly in market-traded securities (as described in paragraphs 2.30 through 2.33), should, instead of disclosing annual total returns before and after incentive allocations and fees, disclose the Internal Rate of Return since inception (IRR) of the investment company's cash flows and residual values as presented in the financial statements, net of all incentive allocations or fees, to each investor class, as of the beginning and end of the period. A footnote to the financial highlights should disclose that the IRR is net of all incentives. The IRR should be based on a consistent timing assumption, no less frequently than quarterly, as to the timing of cash inflows and outflows (for example, on actual cash flow dates or cash inflows at the beginning of each month or quarter and cash outflows at the end of each month or quarter). All significant assumptions should be disclosed in the footnotes to the financial highlights.

15. Paragraphs 7.87 through 7.89 are added to provide illustrative examples for calculating and disclosing certain financial highlights by nonregistered investment partnerships:

Illustrations of Calculations and Disclosures When Reporting Expense and Net Investment Income Ratios

7.87 The following are illustrations of average net assets (ANA) computations related to determining expense and net investment income ratios, in which there are various capital flows, assuming a single class of investment interest. Other ANA computation methods (for example, summing and averaging monthly net assets, including the beginning and ending net assets for the year, or a method that also weights ending net assets) are also appropriate if the result is reasonable and consistently applied.

Example 1: Computation of average net assets in a nonregistered investment fund that allows quarterly contributions and distributions and has quarterly accounting periods (that is, capital can flow in and out only at these times):

Net assets at the beginning of the period:	$\$100,000,000 \times 3/12 =$	\$ 25,000,000
Valuation adjustment of \$10 million and capital contribution of \$25 million at April 1, 2002:	$\$135,000,000 \times 3/12 =$	\$ 33,750,000
Valuation adjustment of \$(5) million, capital contribution of \$10 million, and capital withdrawals of \$30 million at July 1, 2002:	$\$110,000,000 \times 3/12 =$	\$ 27,500,000
Valuation adjustment of \$20 million, capital contribution of \$15 million, and capital withdrawals of \$25 million at October 1, 2002:	$\$120,000,000 \times 3/12 =$	<u>\$ 30,000,000</u>
Average net assets		<u>\$116,250,000</u>

Example 2: Computation of average net assets in a nonregistered private equity fund that does not have predetermined accounting periods (that is, capital can be called and distributed at any time), with significant write up in fair value during the year:

Net assets at the beginning of the period:	$\$100,000,000 \times 2/12 =$	\$ 16,666,667
\$25m Capital call at February 28, 2002:	$\$125,000,000 \times 1/12 =$	\$ 10,416,667
\$20m Write-up at March 31, 2002:	$\$145,000,000 \times 6/12 =$	\$ 72,500,000
\$55m Capital call at September 30, 2002:	$\$200,000,000 \times 1/12 =$	\$ 16,666,667
\$25m Distribution at October 31, 2002:	$\$175,000,000 \times 2/12 =$	<u>\$ 29,166,667</u>
Average net assets		<u>\$145,416,668</u>

Disclosure for Incentive and Allocation Fees

For incentive fee:	
Operating (and interest/short dividends) expense	x.xx%
Incentive fee	<u>xx.xx%</u>
Total expenses	<u>xx.xx%</u>
For incentive allocations:	
Operating (and interest/short dividends) expense	x.xx%
Incentive allocation	<u>xx.xx%</u>
Total expenses and incentive allocation	<u>xx.xx%</u>
<p><i>The expense ratio (expense and incentive allocation ratio) is calculated for each common class taken as a whole. The computation of such ratios based on the amount of expenses and incentive fee or incentive allocation assessed to an individual investor's capital may vary from these ratios based on different management fee and incentive arrangements (as applicable) and the timing of capital transactions.</i></p>	

Illustration of Calculation and Disclosure When Reporting the Total Return Ratio

7.88 The following is an illustration of how to compute Internal Rate of Return since inception (IRR) for nonregistered investment partnerships that meet the criteria described in paragraph 7.68(d). Other nonregistered investment partnerships should calculate a total rate of return as described in paragraph 7.68(c) and illustrated in paragraph 7.89.

The following illustrates how an IRR is computed by a venture capital investment partnership, from the perspective of the investor, at the end of its first and second years of operations. The formula used to compute the IRR is: $0 = CF_0 + (CF_1/(1+IRR)) + (CF_2/(1+IRR)^2) + \dots + (CF_T/(1+IRR)^T)$.

Assume that Year 01 activity includes: an initial investment (capital contribution) on January 1 of \$1,000,000, \$50,000 of appreciation (profit) reported on March 31, an additional capital contribution of \$1,000,000 on April 1, additional appreciation of \$80,000 reported on June 30, a distribution of \$500,000 on July 1, and depreciation (loss) of \$30,000 reported on December 31, resulting in a residual value on December 31, 01 of \$1,600,000. The "residual value," which is the fair value of the investments at the end of the period and is considered a theoretical distribution, is calculated as follows: \$1,000,000 (initial capital contribution) plus \$1,000,000 (additional capital contribution) minus \$500,000 (cash distribution) plus the net gain of \$100,000 (50,000 + 80,000 – 30,000) equals \$1,600,000.

Assume that Year 02 activity includes: \$150,000 of appreciation (profit) reported on March 31, a capital contribution of \$500,000 on April 1, \$350,000 of additional appreciation (profit) reported on June 30, \$150,000 of additional appreciation (profit) reported on September 30, a distribution of \$300,000 on December 14, and \$150,000 of depreciation (loss) reported on December 31, resulting in a residual value on December 31, 02 of \$2,300,000 (calculated the same way as in Year 01).

Date	Description	Capital call	Cash Distribution	Residual Value	IRR Cash Flows	
					Through 12/31/01	Through 12/31/02
1-Jan-01	Initial contribution	1,000,000			(1,000,000)	(1,000,000)
1-Apr-01	Additional capital contribution	1,000,000			(1,000,000)	(1,000,000)
1-Jul-01	Cash distribution		500,000		500,000	500,000
31-Dec-01	Residual Value			1,600,000	1,600,000	N/A
1-Apr-02	Additional capital contribution	500,000				(500,000)
14-Dec-02	Distribution		300,000			300,000
31-Dec-02	Residual Value			2,300,000		2,300,000
IRR through December 31, '01					6.69%	
IRR through December 31, '02						16.68%

The following illustrates the note disclosure of the IRR by the venture capital investment partnership at the end of the second year of operations based on the assumptions outlined above.

Note X -- Financial Highlights

The Internal Rate of Return since inception (IRR) of the Limited Partners, net of all fees and profit allocations (carried interest) to the manager (general partner), is 6.7% through December 31, 01 and 16.7% through December 31, 02.

The IRR was computed based on the actual dates of the cash inflows (capital contributions), outflows (cash and stock distributions), and the residual value of the Limited Partners' capital account as of each measurement date.

7.89 The following are illustrations on how to compute the total return ratio for nonregistered investment partnerships as required by 7.68(c):

Example 1: The following are illustrations of how a geometrically linked cash flow is computed assuming a beginning equity of \$1,000,000, a capital contribution of \$1,000,000 on April 1, and a capital withdrawal of \$500,000 on July 1:

Percent Return							
Period	Cash Flows	Beginning Equity	Period Return	Ending Equity	Period	Year to Date	Year to Date Formula
1/1 - 3/31		1,000,000	50,000	1,050,000	5.00%	5.00%	$(1+0.05)^{-1}$
4/1 - 6/30	1,000,000	2,050,000	80,000	2,130,000	3.90%	9.10%	$[(1+0.05)*(1+0.0390)]^{-1}$
7/1 -12/31	(500,000)	1,630,000	(30,000)	1,600,000	(1.84)%	7.09%	$[(1+0.0910)*(1-0.0184)]^{-1}$

Example 2: The following is an illustration of a presentation of total return considering an incentive allocation or fee:

Limited Partner or Common Class	
Total return before incentive allocation/fee	10.00%
Incentive allocation/fee	(1.60%)
Total return after incentive allocation/fee	8.40%
<p><i>Total return is calculated for each common class taken as a whole. An individual investor's return may vary from these returns based on participation in hot issues, private investments, different management fee and incentive arrangements (as applicable) and the timing of capital transactions.</i></p>	

16. Paragraph 7.90 is added to provide an illustrative example of the condensed schedule of investments:

7.90 The following is an illustration of a condensed schedule of investments. Net assets are assumed to be \$50,000,000.

Condensed Schedule of Investments

December 31, 20XX

Principal Amount, Shares or No. of Contracts	Description	Fair Value
	COMMON STOCKS (54.6%)	
	United States (33.5%)	
	Airlines (7.2%)	
53,125	Flight Airlines, Inc.	\$1,811,297
	Other (3.6%)	<u>1,819,074</u>
		3,630,371
	Banks (1.9%)	937,099
	Financial Services (2.8%)	1,433,210
	Foods (7.1%)	
106,607	Andrews Midlands Co.	2,825,078
	Other (1.4%)	<u>702,824</u>
		3,527,902
	Hospital Supplies and Services (5.6%)	
100,404	Chelsea Clinics Inc.	2,811,297
	Technology (4.0%)	2,039,578
	Utilities (4.9%)	<u>2,480,556</u>
	Total United States (cost \$16,850,954)	16,860,013
	Hong Kong (5.7%)	
	Drugs (0.6%)	330,741
	Retail (4.0%)	1,984,445
	Utility Telephone (1.1%)	<u>552,235</u>
	Total Hong Kong (cost \$2,756,959)	2,867,421
	Italy (5.6%)	
	Airlines (0.2%)	110,247
	Financial Services (1.8%)	881,975
	Leisure Related (3.5%)	1,763,951
	Office Supplies (0.1%)	<u>55,123</u>
	Total Italy (cost \$2,912,465)	2,811,296
	Spain (5.4%)	
	Banks (2.4%)	1,212,716
	Oil (1.7%)	826,852
	Railroads (1.3%)	<u>661,482</u>
	Total Spain (cost \$2,643,197)	2,701,050
	United Kingdom (4.4%)	
	Financial Services (2.3%)	1,157,593
	Technology (2.1%)	<u>1,047,346</u>
	Total United Kingdom (cost \$2,145,246)	2,204,939
	TOTAL COMMON STOCKS (cost \$27,308,821)	<u>27,444,719</u>

	DEBT SECURITIES (41.2%)	
	United States (21.4%)	
	Airlines (2.0%)	
\$1,000,000	Flight Airlines Inc. 12%, 7/15/05	1,000,000
	Government (19.4%)	
\$3,000,000	U.S. Treasury Bond, 4.50%, 11/15/07	3,031,791
	U.S. Treasury Bonds, 3.00%- 4.75%, 1/30/05 - 7/15/07	<u>6,686,175</u>
		<u>9,717,966</u>
	Total United States (cost \$15,015,200)	10,717,966
	Mexico (19.8%)	
	Government	
	United Mexican States, 8.625% - 9.125% 3/12/08 - 12/7/09 (cost \$10,000,000)	9,922,224
	TOTAL DEBT SECURITIES (cost \$25,015,200)	20,640,190
	LONG PUT AND CALL OPTIONS (2.4%)	
	United States	
	Telecommunications (cost \$1,225,800)	1,212,716
	INTEREST IN INVESTMENT PARTNERSHIP (10.0%)	
	(cost \$4,000,000)	5,000,000
	XYZ Hedge Fund LP (35% owned) (XYZ Hedge Fund LP owns 6,000 shares, valued at \$9,000,000 of Leisure Cruises Inc., which is a United States Company in the travel Industry. The partnership's share of this investment is valued at \$3,150,000 as of December 31, 20XX.	
	TOTAL INVESTMENTS (108.8%) (cost \$59,125,068)	<u><u>\$54,297,625</u></u>
	SECURITIES SOLD SHORT (5.7%)	
	COMMON STOCKS (5.7%)	
	United States	
	Energy	
100,000	ABC Resources Co. (proceeds \$2,715,000)	\$2,825,078
	DEBT SECURITIES (3.7%)	
	Canada (3.7%)	
	Telecommunications (proceeds \$1,950,000)	1,867,000
	WRITTEN OPTIONS (0.2%)	
	United States (0.2%)	
	Manufacturing (proceeds \$130,000)	127,309
	TOTAL SECURITIES SOLD SHORT (proceeds \$4,795,000)	<u><u>\$4,819,387</u></u>

		<u>Expiration dates</u>	<u>No. of contracts</u>
FUTURES CONTRACTS (12.5%)			
Eurodollar (5.2%)	\$2,611,825	Feb - Apr 200X	122
S&P 500 (5.6%)	2,788,000	Mar-May 200X	89
Metals (1.7%)	840,000		
TOTAL FUTURES CONTRACTS	<u>\$6,239,825</u>		
FORWARDS (11.5%)			
Argentinean Peso (5.8%)	\$2,910,000	Oct-Nov 200X	
Other currencies (5.7%)	2,876,315		
TOTAL FORWARDS	<u>\$5,786,315</u>		
SWAPS (13.4%)			
Interest rate swaps (5.7%)	\$2,875,000		
Currency swaps (7.7%)			
Yen/US Dollar swaps (6.0%)	2,999,016	Jan-Feb 200X	
Other (1.7%)	868,000		
TOTAL SWAPS	<u>\$6,742,016</u>		

The accompanying notes are an integral part of these financial statements.

EFFECTIVE DATE AND TRANSITION

17. The provisions of this SOP are effective for annual financial statements issued for fiscal years ending after December 15, 2003, and for interim financial statements issued after initial application. Presentation of previously issued financial highlights on a comparable basis is permitted, but not required. The provisions of the SOP should be applied prospectively from the beginning of the year of adoption.

The provisions of this Statement of Position need not be applied to immaterial items.

APPENDIX A – BASIS FOR CONCLUSIONS

Condensed Schedule of Investments

Additional Disclosures for Investments by Nonregistered Investment Partnerships in Other Nonregistered Investment Partnerships

A-1. The Accounting Standards Executive Committee (AcSEC) discussed whether disclosures in addition to those required by paragraph 7.12 of the AICPA Audit and Accounting Guide *Audits of Investment Companies* (Guide) and paragraph 11 of AICPA Statement of Position (SOP) 95-2, *Financial Reporting by Nonpublic Investment Partnerships* (as amended by SOP 01-1, *Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools*), should be required for investments in nonregistered investment partnerships by funds-of-funds. Paragraph 7.12 of the Guide and paragraph 11 of SOP 95-2 require the presentation of a condensed schedule of investments in the financial statements of investment partnerships and require, among other items, disclosure in the condensed schedule of investments of *the name, shares or principal amount, value, and type* of each investment (including short sales), constituting more than 5 percent of net assets.

A-2. The hedge fund industry has seen the increasing use of investments in other nonregistered investment partnerships, particularly in the area of funds-of-funds. There is financial statement issuer, user, and regulatory concern over whether merely disclosing the name of a nonregistered investment partnership in an investment portfolio by itself provides meaningful information to the financial statement user. AcSEC believes that a qualitative description of the investee's principal investment strategies would allow for a better understanding of the nature of the investment.

A-3. AcSEC concluded that a qualitative description of each investee fund exceeding 5 percent of net assets should be included in the financial statements to permit the financial statement user to more fully understand the nature of the investment. The summary of qualitative disclosure may be made either in the schedule of investments, a note thereto, or in the notes to the financial statements.

Presentation of Derivatives in the Condensed Schedule of Investments

A-4. AcSEC discussed whether derivatives should be required to be presented in the condensed schedule of investments based on a method that would result in a consistent presentation of similar contracts by funds of similar size.

A-5. AcSEC observed that, upon the issuance of SOP 01-1, *Amendment to Scope of Statement of Position of 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools*, which extended the requirements of SOP 95-2 to many commodity pools registered with the Commodity Futures Trading Commission (CFTC), SOP 95-2 was being applied to funds with much greater levels of derivatives activity than had been the case previously. Paragraph 7.12 of the Guide requires disclosure of derivative positions exceeding 5 percent of net assets based on their fair value. Questions have been raised as to whether the fair value of a derivative position is always the best determinant of whether information about that position should be presented in the schedule of investments, or whether other determinants, such as notional amounts, would result in more useful reported information.

A-6. AcSEC agreed that fair value of a derivatives position is in most cases the appropriate measure of its significance. AcSEC noted that paragraph 512 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, concluded that disclosures of notional amounts should not be required, stating, "...although the face or contract amount of

derivative instruments held provides some indication of derivatives activity, their usefulness for that purpose may be suspect given that some derivatives are commonly neutralized either by canceling the original derivative—which lowers the reported amount or by acquiring or issuing an offsetting derivative—which increases the reported amount.” However, AcSEC agreed that for open futures contracts of a particular underlying, cumulative appreciation (depreciation) is a better determinant of whether information about that position should be presented in the schedule of investments, because it results in a consistent presentation of similar contracts by funds of similar size.

A-7. AcSEC concluded that the information disclosed about derivative positions in the condensed schedule of investments should reflect the market risk of an investment company’s significant investments. Accordingly, AcSEC concluded that derivatives should be summarized by type of instrument and underlying (for example, specific equity index, U.S. Treasury Bond, or natural gas) and presented, for open futures contracts, on the basis of cumulative appreciation (depreciation) and for all other derivatives, fair value at period end, with the number of contracts and range of expiration dates identified in the condensed schedule of investments for those derivatives in excess of 5 percent of net assets. AcSEC concluded that, if the underlying is not a security, summarization of the derivative positions by country or geographic region and industry may be of limited applicability in certain cases, and that summarization by broad category of underlying provides relevant and usable information to users.

A-8. This SOP also amends footnote 13 to Chapter 7 of the Guide to clarify that only investment partnerships regulated as brokers and dealers in securities under the Securities Exchange Act of 1934 that manage funds for those who are officers, directors, or employees of the general partner are excluded from the requirement to provide a portfolio of investments under paragraph 7.12.

Financial Highlights

A-9. AcSEC concluded that the Guide should be amended to clarify the application of certain provisions to result in more meaningful financial highlights disclosures for nonregistered investment partnerships. Those provisions needed clarification because of the inherent operational and tax differences between an investment company registered under the Investment Company Act of 1940 and a nonregistered investment partnership. AcSEC’s basis for conclusions to amend the financial highlights disclosures provisions is as follows.

Clarification of Certain Terms

A-10. AcSEC observed that although the disclosure of financial highlights (as required by the Guide) applies to both registered investment companies and nonregistered investment partnerships, the Guide focuses primarily on registered investment companies, and thus certain terms are not readily applicable to nonregistered investment partnerships. Therefore, AcSEC concluded that terms such as *classes*, *units*, and *theoretical investment* should be clarified for nonregistered investment partnerships.

Disclosure of Per Share and Per Unit Data

A-11. AcSEC also concluded that the information required to be disclosed in the per share data required by paragraph 7.66 of the Guide should be clarified for nonregistered investment partnerships. AcSEC concluded that nonregistered investment partnerships should disclose information for each reporting share class related to nonmanaging investors. AcSEC notes that, generally, a “class” has certain rights as governed by underlying legal documents or offering documents, and local law. Rights to certain investments that do not otherwise affect the rights available under the underlying legal documents or offering and local law do not ordinarily represent a separate share class. For example, rights to income and gains from a specific investment attributed solely to investors at the date the investment

is made ("side-pocket" investments) are not considered a share class. Similarly, a temporary series of shares (for example, a series established to track interim computations of incentive allocations or fees and then exchanged into a permanent series when the interim period is completed) is not considered a share class.

Determining Average Net Assets When Computing Financial Ratios and Computation of the Expense and Net Investment Income Ratios

A-12. AcSEC discussed how the current requirement of paragraph 7.67 of the Guide to disclose the expense and net investment income ratio to average net assets should be applied to produce useful information to investors of nonregistered investment partnerships.

A-13. AcSEC observed that the calculation of meaningful expense and net investment income ratios depends on the nonregistered investment fund's ability to calculate meaningful average net assets (ANA) values by class of investment interest. The more frequently a nonregistered investment fund measures its net assets, the more meaningful the ANA will be.

A-14. AcSEC concluded that when a nonregistered investment partnership computes expense and net investment income ratios, the ANA should be calculated using the fund's (or class') weighted ANA as measured at each accounting period (for example, daily, weekly, monthly, quarterly) and any other period when capital is contributed or withdrawn from the fund. If a fund does not have predetermined accounting periods (for example, certain venture capital partnerships) and capital is called and distributed at various times during the year, the net asset values used in the computation of ANA should be weighted and should include a measure of net assets after each capital contribution or distribution and each significant change in net assets.

A-15. AcSEC considered whether nonregistered investment partnerships for which a majority of expenses are based on a percentage of committed capital, rather than average net assets, should present their expense and net investment income ratios as a percentage of committed capital rather than ANA. AcSEC considered that such a presentation could enhance the comparability of expense ratios between commitment-based partnerships that, as an operating practice, call capital from investors only as investments are identified and those that call significant amounts of capital prior to such identification. Additionally, AcSEC considered that this practice would avoid having a partnership report substantial fluctuations in expense ratios over time even though the contractual basis for the expenses had not changed. However, AcSEC concluded that, because expenses can only be paid from assets actually held by the partnership, not committed capital, an ANA-based expense ratio more appropriately reflects the proportion of the resources available to the partnership that were used during the period to meet its operating expenses.

A-16. AcSEC also concluded that expense and net investment income ratios should be calculated based on the expenses allocated to each common or investor class (for example, the limited partner class) prior to the effects of any incentive allocation. Adequate disclosures should be made so that it is clear to users that the net investment income ratio does not reflect the effects of any incentive allocation.

A-17. AcSEC observes that, generally, the determination of expenses for computing the expense ratio should follow the presentation of expenses in the fund's statement of operations. Accordingly, if the manager's or general partner's incentive is structured as a fee rather than an allocation of profits, the incentive fee would be factored into the computation of the expense ratio. Because an incentive allocation of profits is not presented as an expense, it should not be considered part of the standard expense ratio. However, to avoid potentially significant inconsistencies in ratio presentation based solely on the structuring of incentives as fees or allocations, all incentives should be reflected in the disclosure of financial highlights. Additionally, disclosure should be made in the expense ratio of the effect

of any agreement to waive or reimburse fees and expenses to each reporting class as a whole, as described in paragraph 7.38 of the Guide, and of expense offsets, as described in paragraphs 7.40 and 7.41 of the Guide. Agreements to waive a portion or all of certain fees to a specific investor which do not relate to the share class as a whole do not require disclosure in the financial highlights. However, as ratios are calculated for each common class taken as a whole, the financial statements should disclose that an individual investor's ratio may vary from those ratios.

Additional Financial Highlights Disclosures for Certain Limited-Life Nonregistered Investment Partnerships

A-18. AcSEC observed that because investments in certain limited-life nonregistered investment partnerships (typically venture capital partnerships and private equity funds) involve long-term commitments and investment performance depends upon the deployment of committed capital, other key comparative factors among those partnerships are of importance to investors, such as (a) total amount of capital commitments of investors, (b) the year of formation of the entity and the year that the entity made its first investment, and (c) ratio of total contributed capital to total committed capital. Therefore, AcSEC concluded that those disclosures were useful and meaningful, and should be required to be disclosed in the financial highlights by those partnerships.

Computation of Financial Ratios by Funds-of-Funds and Master-Feeder Funds

A-19. AcSEC discussed how nonregistered funds-of-funds and master-feeder funds should calculate expense and net investment income ratios. As stated in paragraph 13 of this SOP, the determination of expenses for computing those ratios should follow the presentation in the fund's statement of operations. Therefore, funds-of-funds typically should compute these ratios based on the net investment income and expense items at the fund-of-funds level only. In the statement of operations, earnings from investee funds usually are not considered a component of net investment income. Therefore, AcSEC concluded that the funds-of-funds' proportionate share of the expenses and profits of the underlying investee funds generally would not be considered when calculating these ratios. Additionally, AcSEC believes that adequate disclosure should be made so that it is clear to users that the ratios do not reflect the funds-of-funds' proportionate share of income and expenses of the underlying investee funds.

Computation of the Total Rate of Return

A-20. AcSEC discussed how a nonregistered investment partnership should compute the change in value of a theoretical investment when disclosing the total rate of return as required by paragraph 7.68(c) of the Guide.

A-21. AcSEC concluded that the change in value of a theoretical investment for a nonregistered investment partnership, except for certain limited-life nonregistered investment partnerships, is measured by comparing the aggregate ending net asset value of each class of investor with the aggregate beginning net asset value of each such class, adjusted for cash flows related to capital contributions or withdrawals during the period. If capital cash flows occur during the reporting period, returns are geometrically linked based on capital cash flow dates. In general, "geometrically linking" requires the computation of performance for each discrete period within a year for which invested capital is constant (that is, for each period between investor cash flow dates), then multiplying those performance computations together to obtain the total return for a constant investment outstanding for the entire year. Additionally, because incentive allocations or fees may vary among investors within a class, total return for reporting classes subject to an incentive allocation or fee should report total return before and after the incentive allocation or fee for each reporting class taken as a whole. The effect of incentive allocations on total return is computed on a weighted average aggregate basis. That may result in an incentive

computation less than the maximum if, for example, certain partners had loss carryovers at the beginning of the period.

Reporting Total Return for Certain Limited-Life Nonregistered Investment Partnerships

A-22. Preparers of financial statements of limited-life investment partnerships, in particular venture capital investment partnerships, have indicated that the total return computation required by paragraph 7.68 of the Guide focuses on single-year returns and ignores the long-term nature of venture capital partnerships. Further, the “geometric linking” calculation methodology, which this SOP requires for other investment partnerships, can distort actual returns of venture capital investment partnerships by, for example, reporting overall negative returns when large profitable investments are sold and distributed to investors early in the year and the value of the small residual balances declines for the remainder of the year.

A-23. Those preparers indicate that these concerns arise because venture capital investment partnerships typically invest to form or develop companies with new ideas, products, or processes with a primary investment objective of long-term capital growth and realize gains on those investments over a relatively long holding period. The investments are typically in privately held companies whose securities have no ready market and are illiquid. The value of the investments increases over time as effort is expended and product is developed. Further, under the terms of their offering agreements or organization documents, these partnerships normally have limited lives, requiring disposition of investments purchased. However, disposition of the investments typically does not occur within a single year. AcSEC considered that investors typically are not provided the opportunity to redeem their interests in the partnership, and that transfers to other owners of partnership interests are extremely rare due to contractual and legal restrictions. Accordingly, investors typically realize returns only upon disposition of the investments and distribution of the proceeds or by the distribution of the investments themselves, not by an earlier sale of interests in the partnership. Thus investors, and even the partnership itself, may consider single-year return of limited value in measuring the overall investment performance of a venture capital investment partnership.

A-24. Additionally, the investment decision by an investor in venture capital investment partnerships occurs at the time of fund formation. The total size of the investment pool for venture capital investment partnerships typically is fixed at formation. All investors make proportionate capital contributions based on their capital commitments at the same time when cash resources are required by the venture capital investment partnership in order to carry out its affairs. Combined with restrictions on redemption, the cash flows into or out of a venture capital investment partnership are totally outside the control of the investor.

A-25. Historically, investors in venture capital investment partnerships have evaluated overall returns on their commitments to such entities by taking into account the pace of the capital deployment over the life of each entity by the manager, the timing of distributions from the entity back to the investor, and, prior to the termination of the entity, the residual value of the investors' interest in the entity. The most common measure for this purpose has been the Internal Rate of Return since inception (IRR) because it reflects the effects of the timing of the cash flows. IRR is a commonly recognized performance measure used by investors and investment professionals within the venture capital community. The IRR measure is sometimes the basis on which general partners or investment managers are compensated, and it is generally provided to investors. Numerous “cash flows” and residual values are capable of being measured by an IRR.

A-26. AcSEC believes that the performance measures described in paragraph 7.68 of the Guide (total return based on unitized net assets value and on theoretical investment) are not the most relevant performance measures for a venture capital investment partnership, primarily because those measures reflect the cash flows controlled by the investor, rather

than the cash flows controlled by the manager of the venture capital partnership. AcSEC concluded that IRR is a better measure of the performance of a venture capital partnership because it reflects the cash flows controlled by the manager of the partnership. AcSEC also discussed whether the IRR calculation would produce any difficulties or mathematical problems. AcSEC considered that mathematical problems are uncommon because the total number of investors is generally fixed at the formation, the fund has a limited life, and the nature of the cash flows is not complicated. AcSEC concluded that venture capital investment partnerships should use an IRR as a performance measurement ratio instead of the annual total rate of return. AcSEC, however, determined that only investment companies that meet the typical operating characteristics of venture capital investment partnerships, that is, limited life, commitments from investors only at the time of fund formation, inability to request redemption of investment interests, typical return of the proceeds from disposition of investments to investors, limited opportunities, if any, for investors to withdraw prior to termination of partnership, and typical holdings of non-marketable investments, should be provided this alternative measure. AcSEC considered indefinite life, continual replenishment of capital, ability to request redemption of investment interests, frequent reinvestment of proceeds, and frequent purchase of investments that are market-traded (and thus presumed to be readily convertible to cash) to be factors indicating that an annual rate of return would be a useful and preferable measure for partnerships exhibiting those characteristics.

A-27. AcSEC acknowledged that the basic principles of IRR calculation are reasonably well-known and numerous software programs exist for the calculation of IRR. However, AcSEC determined that a range of simplifying assumptions exists in measuring the timing of cash flows to assist in the calculation, such as assuming that all cash inflows occur at the beginning, and all cash outflows occur at the end, of uniform monthly or quarterly reporting periods. AcSEC concluded that the timing assumptions used should be disclosed in the financial statements so users can understand the underlying calculation method, and that the reporting period used should be no less frequent than quarterly to avoid potential distortions in calculations.

A-28. This SOP requires that, unlike for other funds, only a single IRR after incentives would be presented, instead of the returns gross and net of incentive allocations or fees provided by other funds. AcSEC considered that there were significant computational difficulties in determining annualized returns before and after incentives. Further, AcSEC considered that in many instances all investors in the funds to which IRR would apply are charged incentives at a uniform rate, so that the concerns about varying incentive rates and loss carryforward periods that gave rise to the “gross and net” calculations proposed for other funds are substantially less likely to exist among these funds.

APPENDIX B – EFFECT ON OTHER PRONOUNCEMENTS

B-1. This Statement of Position (SOP) amends the reporting provisions established by American Institute of Certified Public Accountants (AICPA) SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*.¹

Paragraph 11 of SOP 95-2 is amended by adding the guidance shown in italics and underlined:

Condensed Schedule of Investments

.11 *Schedule of Investments.* The financial statements of an investment partnership, when prepared in conformity with GAAP, should, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule should do the following.

- a. Categorize investments by the following:
 1. Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)
 2. Country or geographic region
 3. Industry

Report the percent of net assets that each such category represents and the total value and cost for each category in (a)(1) and (a)(2). *Derivatives for which the underlying is not a security should be categorized by broad category of underlying (for example, grains and feeds, fibers and textiles, foreign currency, or equity indices) in place of categories (a)(2) and (a)(3).*

- b. Disclose the name, shares or principal amount, value, and type of the following:
 1. Each investment (including short sales), constituting more than 5 percent of net assets *except for derivative instruments as discussed in (d) and (e) below.*
 2. All investments in any one issuer aggregating more than 5 percent of net assets *except for derivative instruments as discussed in (d) and (e) below.*

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

- c. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments and categorize them as required by (a) above.

¹ As amended by AICPA Statement of Position 01-1, *Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools.*

d. Disclose the number of contracts, range of expiration dates, and cumulative appreciation (depreciation) for open futures contracts of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets.

e. Disclose the range of expiration dates and fair value for all other derivatives (such as forwards, swaps [such as interest rate and currency swaps], and options) of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds) regardless of counterparty, exchange, or delivery date, where fair value exceeds 5 percent of net assets.

f. Provide the following additional qualitative description for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets:

- the investment objective
- restrictions on redemption (that is, liquidity provisions)
- either the total amount of management fees and incentive allocations or fees borne indirectly during the period, or the management fee and incentive allocation/fee rates applicable to the investment.